



Rate Guiding Principles

Action Required

Approve recommendation to adopt guiding principles for the Department of Technology Services' cost allocation and rate setting methodologies.

Introduction

This agenda item discusses the recent Department of Technology Services (DTS or Department) rate assessment's guiding principles. In addition, this agenda item recommends that the Technology Services Board (TSB) adopt DTS guiding principles for cost allocation and rate setting methodologies.

Rate Assessment and Guiding Principles

Rate Assessment. In June 2005, the former Stephen P. Teale Data Center and the Health and Human Services Agency Data Center contracted for consulting services to (1) assess the data centers' rate structures, (2) identify problems with those rate structures, and (3) make recommendations on how to resolve those problems and move to a single DTS rate schedule. Agenda 5D, Appendix A, is the executive summary of the rate assessment.

Rate Assessment Proposes Guiding Principles. The assessment found that the DTS would benefit from adopting a set of guiding principles for cost allocation and rate setting methodologies. Without these principles, the DTS may have similar difficulties in its rate setting functions that the two previous data centers experienced. For example, both data centers were unable to increase rates, which lead to over-collection of revenues on mainframe services in order to cover expenses on non-mainframe services. A guiding principle that stated rates should produce revenues that match expenses may have prevented some of these problems. The assessment proposes a number of guiding principles found in Appendix A.

Many Benefits in Adopting Guiding Principles. In the Department's view, the guiding principles provide a framework for establishing policies and procedures for cost allocation, cost accounting, and rate development. In addition, the guiding principles can be used to help lead the DTS towards consistency and uniformity in our rate policies and procedures. The primary theme in the assessment's guiding principles is that rates should match the cost of providing the service. This theme is consistent with federal law and state policy.



Guiding Principles Do Not Recognize Special Circumstances. The DTS agrees with the assessment's recommendation to adopt the guiding principles. In the DTS' review of the guiding principles, however, it found that the guiding principles do not recognize some of the special cost issues that the DTS may face in either starting up a new service or transitioning customers to more efficient technologies. For example, when establishing a new service, it may not be reasonable to charge the first DTS customer all the costs related to implementing the new service's hardware and software—especially when those costs would eventually be shared by many DTS customers. The other circumstance that may occur is when costs increase significantly because the current technology supporting the service becomes out of date. In this circumstance, the cost may increase much quicker than the customer is able to transition to a different technology solution.

In both of these circumstances, the DTS may need flexibility to temporarily disconnect revenues from costs. In these instances, the DTS would need to have a clear policy objective in place for a defined time period in which expenses would be allowed to exceed revenues. In addition, the Department would need to actively manage the period of transition to ensure that its customers are informed of the service change and how it will affect them from both the financial and operational perspectives.

Recommendation

Adopt Assessment's Guiding Principles But Allow Some Exceptions. For these reasons, the DTS recommends that the TSB adopt the assessment's guiding principles. In addition, the DTS recommends that the guiding principles include exception language which would allow expenses to exceed revenues in special circumstances. The exception language can be found in the Guiding Principles for Rate Setting, Appendix A, Item 5.



Appendix A

DEPARTMENT OF TECHNOLOGY SERVICES

GUIDING PRINCIPLES FOR COST ALLOCATION AND RATE SETTING

COST ALLOCATION

The purpose of the guiding principles is to provide the foundation for the Department's cost allocation and rate setting policies and procedures. These principles are intended to provide high-level guidance when evaluating alternate courses of action and provide the criteria against which the Department's policies and procedures for cost allocation, cost accounting, and rate development will be evaluated.

The purpose of the Department of Technology Services (Department) cost allocation methodology is to determine, as accurately as is reasonable, the actual cost of providing services to external customers in order to:

- Provide the basis for setting rates.
- Provide management with the cost data needed to effectively manage its business and service offerings.

The Department's cost allocation principles, developed in accordance with Office of Management and Budget (ONB) Circular A-87 and State Administrative Manual, Section 8752, are as follows:

- Costs should be charged directly to the project, product, process, or activity to which they are attributable to the greatest extent reasonable.
- Costs should be charged to overhead only when they are: (1) not directly chargeable without unreasonable effort; and (2) incurred for a common purpose benefiting more than one project, product, process, or activity.
- All projects, products, processes, or activities that benefit from an overhead activity will receive an appropriate allocation of overhead costs.
- One project, product, process, or activity will not support or subsidize another.
- Similar costs will be accorded consistent treatment throughout the organization.
- Costs must be "reasonable" and "allowable" to be charged to a particular project, product, process, or activity.
- Costs and their allocation methodologies must be adequately documented.

Reasonable Cost: According to OMB Circular A-87, a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under circumstances prevailing at the time the decision was made to incur the cost.

Allowable Cost: According to OMB Circular A-87, a cost allowable is it is necessary and reasonable and conforms to applicable laws and regulations.



RATE SETTING

1. The Department strives to have reasonable rates for comparable services.
2. The Department's rates must be justifiable and supportable.
3. The Department's internal systems should provide accurate and timely cost and activity data for rate setting and billing purposes.
4. Services will be periodically reviewed to determine the most appropriate rate-setting methodology according to the type of service (that is, measured usage, subscription, direct bill).
5. The revenues generated from the rates should fully recover the costs of the service, plus allowable reserves for working capital and equipment replacement. In order to facilitate the adoption of new services and/or the transition of customers to more efficient technologies, this principle may be suspended for a specific service for an actively managed period of transition. This exception will only be made for a documented policy objective and for a defined time period, after which the service is required to be compliant with the principle.
6. The effort required for rate setting should be commensurate with the benefits derived.
7. The rate setting process should provide mechanisms for ongoing rate review from a financial, technical, and business perspective.